

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

may elect to commence the accrual of cash interest on the Senior Discount Notes, in which case the outstanding principal amount on such Notes will be reduced to their accreted value as of the date of such election and cash interest shall become payable thereafter.

The Notes will be subject to redemption at the option of TCG, in whole or in part, at any time on or after July 1, 2001, initially at 104.938% of their principal amount in the case of the Senior Notes, and 105.563% in the case of the Senior Discount Notes and declining to 100% of their principal amount on or after July 1, 2004, in all cases plus accrued and unpaid interest thereon to the applicable redemption date. The incurrence of long-term indebtedness by TCG is subject to approval by the New York Public Service Commission (the "NYPSC") and the New Jersey Board of Public Utilities (the "NJBPBU"). Both the NYPSC and NJBPBU have authorized TCG to issue long-term debt in amounts not to exceed \$4 billion.

The fair value of TCG's long-term debt is estimated based on the quoted market price for the same or similar issues or on borrowing rates currently available to TCG for debt with similar terms and maturities. The fair value of TCG's long-term debt was \$1.2 billion and \$1.1 billion at December 31, 1997 and 1996, respectively. The total interest expense for the Notes was \$105.0 million and \$49.3 million for the years ended December 31, 1997 and 1996, respectively.

The Revolving Credit Agreement

On May 22, 1995, TCG entered into a Loan Agreement (the "Revolving Credit Agreement") with Toronto Dominion (Texas), Inc., as administrative agent, Chemical Bank, as documentation agent, and the Banks (as defined in the Revolving Credit Agreement) to finance capital expenditures and working capital needs of TCG's subsidiaries and of the Local Market Partnerships and to repay debt of TCG and its subsidiaries to the Cable Stockholders. Borrowings of \$250 million were utilized for the growth of TCG. The \$250 million of indebtedness under the Revolving Credit Agreement was repaid in July 1996 from the proceeds of the 1996 Offerings.

On July 28, 1997, TCG, through a wholly-owned subsidiary, TCG New York, Inc. ("TCGNY") amended its \$250 million Revolving Credit Agreement to a \$400 million Revolving Credit Agreement (the "Revolving Credit Agreement"). The Revolving Credit Agreement is secured by (i) the stock of the following wholly-owned subsidiaries of TCGNY: TC New York Holdings I, Inc., TC New York Holdings II, Inc., TC Systems, Inc., TCG Payphones, Inc. and the partnership interests in Teleport Communications, (ii) a negative pledge with respect to the assets and a pledge of the stock of each existing and future subsidiary of TCGNY, (iii) a negative pledge with respect to the contracts that relate to TCGNY operations, (iv) upstream guarantees from any existing and future subsidiaries of TCGNY, and (v) a lien on all present and future intercompany indebtedness owed to TCGNY from TCG and all of its subsidiaries. The Revolving Credit Agreement provides for interest based upon either the base rate or London Interbank Offered Rate ("LIBOR"), adjusted as defined in the Revolving Credit Agreement. In addition, TCGNY must pay a commitment fee equal to 0.375% per annum on the unused commitment amount. There was no outstanding balance as of December 31, 1997 and 1996. The total interest expense for amounts borrowed and commitment fees under the Revolving Credit Agreement were \$1.2 million, \$6.3 million and \$3.0 million for the years ended December 31, 1997, 1996 and 1995, respectively. At December 31, 1997, the amount available under the Revolving Credit Agreement was \$344.4 million.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

5. Fixed Assets

The following is a summary of the Company's fixed assets as of December 31, 1997 and 1996 (in thousands):

	<u>1997</u>	<u>1996</u>
Communications network	\$1,470,081	\$ 875,152
Construction in progress	252,012	336,770
Other	150,990	92,307
	<u>1,873,083</u>	<u>1,304,229</u>
Less: Accumulated depreciation and amortization	(379,987)	(236,967)
Fixed assets—net	<u>\$1,493,096</u>	<u>\$1,067,262</u>

6. Long-Term Debt and Financial Instruments

Long-term debt outstanding as of December 31, 1997 and 1996 consisted of the following (in thousands):

	<u>1997</u>	<u>1996</u>
Senior Notes, 9.875%, due 2006	\$ 300,000	\$300,000
Senior Discount Notes, net of discount of \$338,622 and \$414,039 in 1997 and 1996, respectively, 11.125% due 2007	734,984	659,567
TCI Subordinated Note, 7.5% due 2001, repaid December 31, 1997 ...	—	27,007
Total	<u>\$1,034,984</u>	<u>\$986,574</u>

All long-term debt matures subsequent to 2002.

Senior Notes and Senior Discount Notes

On July 2, 1996, TCG issued \$300 million principal amount of Senior Notes due 2006 and \$1.073 million aggregate principal amount at maturity of Senior Discount Notes due 2007 (collectively the "Notes"). The Senior Notes were issued pursuant to an indenture (the "Senior Notes Indenture") between TCG and the United States Trust Company of New York, as trustee, and the Senior Discount Notes were issued pursuant to an Indenture (the "Senior Discount Notes Indenture") and, together with the Senior Notes Indenture (the "Indentures") between the Company and the United States Trust Company of New York, as trustee. The Indentures contain certain restrictive covenants which impose limitations on TCG and certain of its subsidiaries' ability to, among other things: (i) incur additional indebtedness, (ii) pay dividends or make certain other distributions and investments, (iii) create liens, (iv) create dividend and other payment restrictions on subsidiaries, (v) incur certain guarantees, (vi) enter into certain asset sale transactions, (vii) enter into certain transactions with affiliates (including the Cable Stockholders) and (viii) merge, consolidate or transfer substantially all of the Company's assets. Under the terms of the Indentures, TCG currently is not able to pay dividends. TCG is currently in compliance with the terms of these covenants.

The Senior Discount Notes were issued at a discount to their aggregate principal amount to generate gross proceeds of approximately \$625 million. The Senior Discount Notes accrete at a rate of 11.125% compounded semi-annually, to an aggregate principal amount of \$1.073 million by July 1, 2001. Thereafter, interest on the Senior Discount Notes will accrue at the rate of 11.125% per annum and will be payable semi-annually on January 1 and July 1, commencing on January 1, 2002; provided that at any time prior to July 1, 2001, TCG

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

4. Marketable Securities

The following is a summary of TCG's marketable securities and cash equivalents at December 31, 1997 and 1996 (in thousands):

1997				
	Amortized Cost	Unrealized Gain	Unrealized Loss	Market Value
Commercial paper	\$124,246	\$ 4	\$ (4)	\$124,246
Federal agency discount notes	33,750	—	(1)	33,749
Federal agency notes	54,524	9	(4)	54,529
Certificates of deposit	55,987	3	(6)	55,984
Corporate medium term notes	93,114	108	(2)	93,220
Corporate notes	15,000	39	—	15,039
Bank notes	19,993	18	—	20,011
	<u>396,614</u>	<u>181</u>	<u>(17)</u>	<u>396,778</u>
Less: Cash equivalents	89,950	—	—	89,950
Marketable securities	<u>\$306,664</u>	<u>\$181</u>	<u>\$ (17)</u>	<u>\$306,828</u>

1996				
	Amortized Cost	Unrealized Gain	Unrealized Loss	Market Value
Commercial paper	\$338,390	\$ —	\$ (83)	\$338,307
U.S. Treasury bills	47,894	33	—	47,927
Federal agency notes	139,481	11	(29)	139,463
Corporate medium term notes	118,825	60	(33)	118,852
Floating rate notes	19,984	16	—	20,000
	<u>664,574</u>	<u>120</u>	<u>(145)</u>	<u>664,549</u>
Less: Cash equivalents	223,743	—	—	223,743
Marketable securities	<u>\$440,831</u>	<u>\$120</u>	<u>\$(145)</u>	<u>\$440,806</u>

The amortized cost and estimated fair value by maturity date as of December 31, 1997 is as follows (in thousands):

	Amortized Cost	Market Value
Due in one year	\$313,490	\$313,505
Due after one year through five years	83,124	83,273
Total	<u>\$396,614</u>	<u>\$396,778</u>

Proceeds from the sale of investments during 1997 and 1996 were \$479.5 million and \$664.8 million, respectively. Gross gains of \$117 thousand and \$57 thousand and gross losses of \$13 thousand and \$2 thousand were realized on these sales in 1997 and 1996, respectively. The change in the net unrealized holding gain from 1997 to 1996 on available-for-sale securities is \$189 thousand.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

Pro Forma Financial Information

Unaudited pro forma financial information for the years ended December 31, 1997 and 1996 as if the TCG Reorganization and the acquisitions of ETC, CERFnet, BizTel, ACC (including US WATS), and KCFN had occurred at January 1, 1996, is as follows (in thousands, except share amounts):

	1997	1996
Revenue	\$ 931,500	\$ 670,312
Net loss	\$ (238,279)	\$ (167,652)
Loss per share	\$ (1.26)	\$ (0.96)
Weighted average number of shares outstanding	188,747,431	173,811,002

Pro forma adjustments for the year ended December 31, 1997 include the reversal of TCG's equity in the losses of ETC and BizTel as well as amortization of the intangible assets relating to the aforementioned acquisition. Pro forma adjustments for the year ended December 31, 1996 include (i) the reversal of TCG's equity in the losses of the 13 Local Market Partnerships and ETC, (ii) amortization of the intangible assets relating to the aforementioned acquisitions and (iii) the reduction of interest expense from the conversion of subordinated debt to parents to equity. The pro forma net loss for the year ended December 31, 1996 excludes the effect of the one-time nonrecurring charge for acquired in-process research and development. The pro forma financial information presented above is not necessarily indicative of the operating results which would have been achieved had the transactions occurred at the beginning of the periods presented or of the results to be achieved in the future.

Cox Fibernet Affiliates

Pursuant to the terms of three Operator Managed Ventures Services Agreements between TCG and certain affiliates of Cox, TCG has options to acquire up to a 35% interest in the competitive access business conducted by such affiliates of Cox in New Orleans, Oklahoma City and the Hampton Roads, Virginia area. To the extent the Cox competitive access provider has derived revenue from any contract entered into by TCG as a result of sales efforts engaged in by TCG on behalf of such Cox operations, the purchase price shall be the ratio of the annual TCG generated revenue to total annual revenue of the Cox operation multiplied by the book value of the assets of the Cox operation. If such ratio is less than 35%, TCG may purchase the balance, up to 35%, of that Cox operation for the fair market value (as determined in accordance with the Operator Managed Ventures Services Agreements) of the operation. There is no cap or maximum purchase price under the terms of the Operator Managed Ventures Services Agreements. In November 1996, TCG notified Cox of its intention to exercise its option to purchase a 35% interest in Cox's Hampton Roads, Virginia operations. The Company's options to acquire 35% interests in Cox's New Orleans and Oklahoma City operations do not mature until 1999. Cox and TCG engaged in discussions concerning the calculation of the purchase price formula for Hampton Roads, Virginia, and a possible renegotiation and restructuring of their respective rights and obligations of the parties under each of the Operator Managed Ventures Services Agreements. However, in connection with the AT&T Merger, Cox and TCG agreed to suspend their negotiations and to toll the option period until the later of six months after the effective time of the AT&T Merger and the contractual trigger date.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

("MergerCo"), and ACC Corp., a Delaware corporation ("ACC"), providing for the merger of MergerCo with and into ACC (the "ACC Merger"), with ACC becoming a wholly-owned subsidiary of TCG. ACC is a switch-based provider of telecommunications services to businesses, residential customers, and educational institutions in the United States, United Kingdom and Canada. ACC has recently commenced operations in Germany. The ACC Agreement provides that ACC's stockholders will receive approximately that number of shares of TCG Class A Common Stock for each ACC share, equal to \$50 divided by the average per share closing price of TCG Class A Common Stock for a ten-day trading period prior to closing of the transaction. In the event, however, that the average per share closing price of TCG Class A Common Stock during the ten-day trading period prior to closing is below \$45, the exchange ratio is fixed at 1.11111 shares of TCG Class A Common Stock for each ACC share, and, if the average per share closing price of TCG Class A Common Stock during the ten-day trading period prior to closing is above \$55, the exchange ratio is fixed at 0.90909 of a share of TCG Class A Common Stock for each ACC share. The total aggregate amount of consideration to be received by the ACC stockholders is expected to be approximately \$1.0 billion.

ACC is presently in the process of acquiring US WATS, Inc., ("US WATS") a domestic U.S. long distance reseller. The US WATS acquisition is expected to be complete in early 1998. ACC has agreed that it will not change the agreement governing the acquisition of US WATS without TCG's consent.

TCG and ACC expect the transaction to be completed by mid-1998, subject to, among other things, approval by a majority of the holders of ACC's outstanding shares. Under the ACC Agreement, ACC has agreed not to solicit or take other actions with respect to any competing proposal, subject to compliance with fiduciary duties. ACC agreed to pay TCG \$32.5 million, plus up to \$7.5 million for expenses, if the ACC Agreement is terminated under certain circumstances.

Upon execution of the ACC Agreement, ACC amended its shareholder rights plan to exempt TCG from the 7.5% threshold by which the rights become exercisable. This amendment will remain in effect until December 31, 1998. In the event that the ACC Merger is completed, the underlying rights granted under the ACC shareholder rights plan will be redeemed by ACC.

Consummation of the ACC Merger is subject to certain closing conditions, including TCG and ACC obtaining required regulatory approvals and other related consents. Accordingly, there can be no assurance that the ACC Merger will be successfully consummated or, if successfully completed, when it might be completed.

Kansas City Fiber Network, L.P.

On December 1, 1997, TCG agreed to acquire the assets and customer base of Kansas City Fiber Network, L.P. ("KCFN"), a leading competitive local exchange carrier in the Kansas City metropolitan area owned by TCI and Time Warner Communications for approximately \$55 million in cash and the assumption of certain liabilities. KCFN currently operates a fiber optic network over 580 route miles which connects to more than 200 on-net buildings. This acquisition is subject to approval from regulatory authorities which is expected in the second quarter of 1998. On June 1, 1997, TCG entered into a Technical Services Agreement with KCFN whereby TCG assumed managerial oversight of the day-to-day operations of KCFN. TCG has recorded the results of operations of KCFN subsequent to that date.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

Eastern TeleLogic Corporation

Effective as of March 1, 1997, TCG completed its acquisition of Eastern TeleLogic Corporation ("ETC"). In the first of two steps, on October 25, 1996, employees of ETC exercised their stock options and then ETC redeemed the shares of its stock (approximately 47%) not held by Comcast CAP, a corporation owned 51% by Comcast and 49% by TCG. Comcast CAP borrowed at a market interest rate approximately \$115 million from TCG as a short-term loan and, in turn, loaned this amount to ETC to effect the redemption. In the second step, TCG acquired Comcast's 51% stock interest in Comcast CAP in exchange for 2,757,083 shares of the Company's Class A Common Stock, resulting in ETC becoming a wholly-owned subsidiary of TCG. After the acquisition, the name of ETC was changed to TCG Delaware Valley, Inc. TCG assumed \$52.6 million of debt in this acquisition. TCG retained an independent third party to fully evaluate certain acquired assets of ETC.

The total acquisition cost for ETC was \$178.7 million. The goodwill recorded with this investment, which represented the excess of the Company's investment over the underlying net assets of ETC, was approximately \$167.8 million. Such amount is being amortized over 40 years and is reported in the statement of operations in depreciation and amortization expense. Amortization expense related to such goodwill for the year ended December 31, 1997 was \$4.2 million.

CERFnet Services, Inc.

On February 4, 1997, the Company acquired from General Atomics and General Atomic Technologies Corporation all of the outstanding capital stock of CERFnet Services, Inc. ("CERFnet"), a leading regional provider of Internet-related services to businesses, including dial-up and dedicated Internet access, World Wide Web hosting, and colocation services and Internet training. TCG issued 2,100,000 shares of its Class A Common Stock to CERFnet's former controlling stockholder and granted to it certain registration rights with respect to such shares of Class A Common Stock. After the acquisition, the name of CERFnet was changed to TCG CERFnet, Inc.

TCG retained an independent third party to evaluate certain of the acquired assets of CERFnet, and as a result of the evaluation, TCG expensed acquired in-process research and development costs of \$22.0 million.

The goodwill recorded with this investment, which represented the excess of the Company's investment over the underlying net assets of CERFnet was approximately \$19.9 million. Such amount is being amortized over 10 years and is reported in the statement of operations in depreciation and amortization expense. Amortization expense related to such goodwill for the year ended December 31, 1997 was approximately \$1.8 million.

Summarized Financial Information

Summarized financial information for the Company's investments, which include BizTel and ETC and six months of the revenues and net losses of the Local Market Partnerships except for TCG St. Louis as of and for the year ended December 31, 1996, is as follows (in thousands):

Total assets	\$ 68,053
Total liabilities	185,820
Total revenues	63,940
Net loss	(52,311)

ACC Merger

On November 26, 1997, TCG entered into an Agreement and Plan of Merger (the "ACC Agreement") by and among TCG, TCG Merger Co., Inc., a Delaware corporation and a wholly-owned subsidiary of TCG

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

Revenue Recognition—Revenue on dedicated line, switch, data, and Internet services is recognized in accordance with the terms of the underlying customer contracts or tariffs and over the period in which the services are provided.

Income Taxes—TCG accounts for income taxes in accordance with the Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes," pursuant to which deferred income tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates currently in effect. State and local taxes are based on factors other than income.

Net Loss Per Share—In 1997, TCG has adopted SFAS No. 128, "Earnings per Share", which had no effect on its computation of loss per share. Net loss per share is determined by dividing net loss by the weighted average number of common shares outstanding for the period. The computation of fully diluted net loss per share was antidilutive in each of the periods presented; therefore, the amounts reported as primary and fully diluted are the same. As part of the TCG Reorganization, TCG declared a 42,000 to one stock split. All per share amounts and numbers of shares have been restated to reflect the stock split retroactive for the periods presented.

Recently Issued Accounting Pronouncements

Comprehensive Income—In June 1997, the Financial Accounting Standards Board ("FASB") issued SFAS No. 130, "Reporting Comprehensive Income." This statement is effective for financial statements issued for periods beginning after December 15, 1997. Management has evaluated the effect on its financial reporting of the adoption of this statement and has found the majority of required disclosures not to be applicable and the remainder not to be significant.

Segments of an Enterprise and Related Information—In June 1997, the FASB issued SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information." This statement is effective for fiscal years beginning after December 15, 1997. SFAS No. 131 requires the reporting of profit and loss, specific revenue and expense items, and assets for reportable segments. It also requires the reconciliation of total segment revenues, total segment profit or loss, total segment assets, and other amounts disclosed for segments, in each case to the corresponding amounts in the general purpose financial statements. The Company has not yet determined what additional disclosures may be required in connection with adopting SFAS No. 131.

3. Acquisitions

BizTel Communications, Inc.

On October 29, 1997, the Company acquired the remaining 50.1% equity interest in BizTel Communications, Inc. ("BizTel") not owned by the Company in exchange for the issuance of 1,667,624 shares of the Company's Class A Common Stock. The Company had previously acquired a 49.9% interest in BizTel, in February 1996. The total acquisition cost was \$40.0 million. BizTel is a holder of Federal Communications Commission ("FCC") licenses to provide telecommunications services utilizing 38 GHz digital milliwave transmission in over 200 geographic areas, which include more than 95 of the 100 largest metropolitan markets and all markets where TCG operates. BizTel's 38 GHz milliwave services can be used to economically connect customers to the Company's fiber optic networks, to provide network redundancy, diverse routing or quick temporary installations and to provide stand-alone facilities where the Company does not have fiber optic networks. As of November 1, 1997, TCG consolidates BizTel's results with its wholly-owned subsidiaries.

TCG evaluated the acquired assets and liabilities of BizTel, and as a result of the evaluation, TCG ascribed a value to the FCC Licenses of \$39.7 million. Such amount is being amortized over 40 years and is reported in the statement of operations in depreciation and amortization expense. Amortization expense related to such FCC Licenses for the year ended December 31, 1997 was \$0.2 million.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

electronics equipment to conform with industry standard, effective December 1, 1995. The effect of these changes increased depreciation expense for the year ended December 31, 1995 by approximately \$0.7 million.

Financial Instruments—Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, marketable securities and accounts receivable. The Company places its temporary cash and cash equivalents and marketable securities with high-quality institutions and, by policy, limits the amount of credit exposure to any one institution. Concentrations of credit risk with respect to accounts receivable are limited due to the dispersion of TCG's customer base among different industries and geographic areas in the United States, by credit granting policies adopted by TCG and by remedies provided by terms of contracts, tariffs and statutes.

Fair Value of Financial Instruments—The estimated fair value amounts have been determined by the Company, using available market information and appropriate valuation methodologies. However, considerable judgment is required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

Investments In and Advances to Unconsolidated Affiliates—Investments in and advances to unconsolidated affiliates at December 31, 1997 represents TCG's interest in three companies which TCG accounts for under the cost method of accounting. At December 31, 1996 it is comprised of TCG's advance to ETC and its 49.9% interest in BizTel.

Goodwill and Other Intangibles—Goodwill represents the excess purchase price paid over the net assets received in the acquisitions of ETC, CERFnet, and the excess purchase price paid over the net assets associated with the purchase of the remaining partnership interests in Teleport Communications, Teleport Communications Boston ("TCB"), TCG Florida, TCG Detroit and TCG San Francisco, as well as goodwill recorded in the financial statements of TCG Pittsburgh, which is included in the consolidated financial statements of TCG after the TCG Reorganization. Goodwill is amortized on a straight-line basis not to exceed 40 years for all entities. The goodwill amortization recorded in 1997, 1996 and 1995 was \$7.9 million, \$2.2 million and \$1.4 million, respectively.

The carrying value of intangible assets is periodically reviewed and impairments are recognized when the undiscounted expected future cash flows, computed after interest expense derived from the related operations, is less than their carrying value.

Licenses—FCC Licenses, acquired in the BizTel acquisition, are amortized over a 40 year period in accordance with industry practice. The amortization recorded in 1997 was \$0.2 million.

Deferred Charges—Deferred charges primarily represent advanced payments made by TCG for rights-of-way and node rents, and are expensed over a maximum period of five years. The current portions of \$4.6 million and \$1.6 million at December 31, 1997 and 1996, respectively, are included in other current assets and the non-current portions, \$8.9 million and \$8.9 million at December 31, 1997 and 1996, respectively, are included in other assets.

Deferred Credits—Deferred credits principally represent advance payments received from customers for long-term fiber optic service, and are amortized into income over the life of the related contracts. The current portions, \$6.7 million and \$2.4 million at December 31, 1997 and 1996, respectively, are included in other current liabilities and the non-current portions, \$15.0 million and \$9.9 million at December 31, 1997 and 1996, respectively, are included in other liabilities.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

2. Significant Accounting Policies

Basis of Presentation—The 1997 consolidated balance sheet and statements of operations and of cash flows include the accounts of TCG and all wholly-owned subsidiaries. The 1996 consolidated balance sheet includes the accounts of TCG and all wholly-owned subsidiaries. The 1996 consolidated statements of operations and of cash flows include equity in losses of unconsolidated affiliates for all the Local Market Partnerships through June 30, 1996 except for TCG St. Louis which was consolidated for the year. As of July 1, 1996, the statements of operations and of cash flows consolidate the operations of the former Local Market Partnerships. For the year ended December 31, 1995, the statements of operations and of cash flows include the combined accounts of TCG and TCG Partners. Investments in which TCG holds less than a 50% interest are accounted for under the equity method. All material intercompany transactions and balances have been eliminated in the financial statements presented.

Basis of Accounting—The accompanying financial statements have been prepared on the accrual basis of accounting.

Use of Estimates—The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash Equivalents—Cash equivalents consist principally of fixed income securities, U.S. Treasury bills, commercial paper, floating rate notes and certificates of deposit with a maturity date of three months or less when purchased.

Marketable Securities—Marketable securities consist principally of fixed income securities, U.S. Treasury bills, commercial paper, floating rate notes, federal agency notes, federal agency discount notes, corporate medium-term notes, corporate notes, bank notes and certificates of deposit with a maturity date greater than three months when purchased and are stated at market value. Market value is determined by the most recently traded price of the security at the balance sheet date. TCG invests primarily in high-grade marketable securities. All marketable securities are classified as available for sale securities under the provisions of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" and unrealized holding gains and losses are reflected as part of stockholders' equity. Net realized gains and losses are determined on the specific identification cost method.

Depreciation and Amortization—Depreciation and amortization are computed on the straight-line basis over the estimated useful lives of the assets or the length of the lease, whichever is shorter. Estimated useful lives are five to 25 years for the communications network and three to five years for other fixed assets, except for buildings which are 40 years.

When depreciable assets are replaced or retired, the amounts at which such assets were carried are removed from the respective accounts and charged to accumulated depreciation and any gains or losses on disposition are amortized over the remaining original asset lives in accordance with industry practice.

During 1995, TCG completed a review of the useful lives of its fixed assets. TCG determined that the lives of certain electronics equipment were longer than industry standard, while the lives of other electronics equipment were shorter than industry standard. Therefore, TCG adjusted the estimated useful lives of certain

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

would have been achieved had the transactions occurred at the beginning of the periods presented or of the results to be achieved in the future.

As of December 31, 1997, TCI, Cox and Comcast owned 42.98%, 34.44% and 22.58%, respectively, of the Company's Class B Common Stock, representing 40.86%, 32.68% and 21.42%, respectively, of the combined voting power of the Company's Common Stock. As of December 31, 1997, TCG was owned 28.49%, 22.37%, 14.66% and 34.48% by TCI, Cox, Comcast and public shareholders, respectively.

The AT&T Merger

On January 8, 1998, TCG entered into an Agreement and Plan of Merger (the "AT&T Agreement") with AT&T Corp., a New York Corporation ("AT&T"), and TA Merger Corp., a Delaware corporation and a wholly-owned subsidiary of AT&T ("AT&T Merger Sub"), pursuant to which, subject to satisfaction of the closing conditions specified therein, AT&T Merger Sub would merge with and into TCG, with TCG surviving as a wholly-owned subsidiary of AT&T (the "AT&T Merger").

In the AT&T Merger, each share of TCG Class A Common Stock (including shares issued to former ACC stockholders in the ACC Merger, assuming that the ACC Merger occurs prior to the AT&T Merger) and each share of the Class B Common Stock of TCG, par value \$0.01 per share (the "TCG Class B Common Stock," and, together with the TCG Class A Common Stock, the "TCG Common Stock") will be converted into 0.943 of a share of AT&T common stock. TCG and AT&T expect that the exchange will be tax-free to TCG stockholders, except to the extent cash is received in lieu of fractional shares. The AT&T Agreement contains customary representations and warranties of the parties, which will not survive effectiveness of the AT&T Merger. In addition, the AT&T Agreement contains certain restrictions on the conduct of TCG's business prior to the consummation of the AT&T Merger. Pursuant to the AT&T Agreement, TCG has agreed, for the period prior to the AT&T Merger, to operate its business in the ordinary course, refrain from taking various corporate actions without the consent of AT&T, and not solicit or enter into negotiations or agreements relating to a competing business combination.

Pursuant to a Voting Agreement among the Cable Stockholders and AT&T, each Cable Stockholder executed and delivered to TCG a written consent in favor of and approving the AT&T Agreement and the AT&T Merger. As a result, so long as the AT&T Agreement is not amended and no provision of it is waived, no further vote or meeting of TCG Stockholders is necessary to approve or consummate the AT&T Merger.

Pursuant to the Voting Agreement, each of the Cable Stockholders, on behalf of itself and certain of its affiliates, also agreed that (i) certain right-of-way, colocation and similar agreements with TCG and its affiliates would be amended as of January 8, 1998 to provide that each such agreement would remain in effect for the longer of five years from such date and the current term of such agreement; and (ii) certain existing facilities agreements, facilities lease agreements or other arrangements (including arrangements relating to future agreements) relating to the lease or other grant of right to use fiber optic facilities between such Cable Stockholder or any of its affiliates and TCG or any of its subsidiaries would be automatically amended as of January 8, 1998 to conform with a form of Master Facilities Agreement agreed to by AT&T, the Cable Stockholders and TCG at the time of the execution of the AT&T Agreement.

Consummation of the AT&T Merger is subject to certain closing conditions, including TCG and AT&T obtaining certain required regulatory approvals and other related consents. Accordingly, there can be no assurance that the AT&T Merger will be successfully consummated or, if successfully completed, when it might be completed.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

TCG Reorganization

Prior to the 1996 Offerings, the Company was owned by the Cable Stockholders. The business was operated through TCG, and beginning in 1992, TCG Partners, which is a New York general partnership owned prior to the TCG Reorganization by the Cable Stockholders in the same percentages as TCG. TCG Partners was formed to invest, with TCG, the Cable Stockholders and other cable operators, in 14 partnerships (the "Local Market Partnerships") to develop and operate local telecommunications networks. The Local Market Partnerships were owned by TCG, and/or TCG Partners, certain of the Cable Stockholders which had cable operations in the particular markets addressed by the Local Market Partnerships, and, in some cases, other cable operators in such markets. To simplify this complex ownership structure, the Company and the Cable Stockholders agreed to consolidate the ownership of TCG Partners and of the Local Market Partnerships as wholly-owned subsidiaries of TCG. As part of this process, certain of the other cable operators agreed to sell their interests in the Local Market Partnerships to TCG directly or through a Cable Stockholder. The financial statements for one of the Local Market Partnerships were previously consolidated with those of TCG. Therefore, TCG consolidated the financial statements of the remaining 13 of the 14 Local Market Partnerships.

Unaudited pro forma financial information for the year ended December 31, 1996, as if the TCG Reorganization had occurred at the beginning of 1996 is as follows (in thousands, except share amounts):

Revenues	\$ 283,383
Expenses:	
Operating	172,374
Selling, general and administrative	98,436
Depreciation and amortization	96,260
Total expenses	367,070
Operating loss	(83,687)
Interest:	
Interest income	29,163
Interest expense	(66,946)
Total interest	(37,783)
Loss before minority interest, equity in losses of unconsolidated affiliates and income tax provision	(121,470)
Minority interest	4,713
Equity in losses of unconsolidated affiliates	(7,650)
Loss before provision for income taxes	(124,407)
Income tax provision	(2,193)
Net loss	\$ (126,600)
Loss per share	\$ (0.86)
Weighted average number of shares outstanding	146,423,705

Pro forma adjustments include the reversal of TCG's equity in the losses of 13 Local Market Partnerships, as well as amortization of the goodwill which was recorded upon closing of the transactions and the reduction of interest expense from the conversion to equity of subordinated debt owed by TCG to the Cable Stockholders. The pro forma financial information presented above is not necessarily indicative of the operating results which

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

1. Organization and Operations

Teleport Communications Group Inc. ("TCG" or the "Company"), the first and largest competitive local exchange carrier ("CLEC") in the United States, offers comprehensive telecommunications services in major metropolitan markets nationwide. TCG competes with incumbent local exchange carriers ("ILECs") by providing high quality, integrated telecommunications services, primarily over fiber optic digital networks, to meet the voice, data and video transmission needs of its customers. TCG's customers are principally telecommunications intensive-businesses, healthcare and educational institutions, governmental agencies, long distance carriers and resellers, Internet service providers, disaster recovery service providers, wireless communications companies and financial services companies. TCG offers these customers technologically advanced telecommunications services, as well as superior customer service, flexible pricing and vendor and route diversity.

TCG, incorporated in March 1983, and TCG Partners, formed in December 1992, were each owned by Cox Communications, Inc. ("Cox"), Tele-Communications, Inc. ("TCI"), Comcast Corporation ("Comcast"), and Continental Cablevision, Inc. ("Continental") (collectively the "Cable Stockholders") until June 26, 1996.

In connection with the public offerings of Class A Common Stock, Senior Notes and Senior Discount Notes on July 2, 1996, TCG and its owners entered into a reorganization agreement dated as of April 18, 1996 (the "TCG Reorganization Agreement"), pursuant to which TCG Partners and certain of the Company's unconsolidated affiliates became wholly-owned subsidiaries of TCG and TCG acquired the minority interests of the owners of the remaining unconsolidated affiliates.

TCG Reorganization and the 1997 and 1996 Offerings

1997 Equity Offering

TCG filed a registration statement for a public offering (the "1997 Offering") of 17,250,000 shares of Class A Common Stock on October 10, 1997, and the 1997 Equity Offering was consummated on November 13, 1997. Of the 17,250,000 shares, 7,304,408 were offered by the Company and 9,945,592 shares were offered by Continental. The Company did not receive any proceeds from the sale of shares by Continental. The net proceeds to the Company from its sale of shares pursuant to the 1997 Equity Offering were approximately \$317.4 million, after deducting the underwriting discount and estimated expenses of approximately \$11.3 million.

1996 Offerings

On July 2, 1996, the Company issued 27,025,000 shares of Class A Common Stock which resulted in gross proceeds of approximately \$432.4 million (the "Stock Offering"), and \$300 million of 9 $\frac{7}{8}$ % Senior Notes due 2006 and \$1,073 million of aggregated principal amount of maturity of 11 $\frac{1}{8}$ % Senior Discount Notes due 2007 ("the Notes Offerings" and, collectively, with the Stock Offering, the "1996 Offerings") as part of an initial public offering. The Offerings of the Senior Notes and the Senior Discount Notes resulted in aggregate gross proceeds of approximately \$925 million. In July 1996, the Company utilized a portion of the net proceeds of the 1996 Offerings to (i) repay \$250 million of bank indebtedness plus accrued interest and (ii) purchase 7,975,738 shares of Class B Common Stock owned by Continental for \$16.00 per share, less related expenses, for a net cost of \$121 million. In addition, a portion of the proceeds was used to loan approximately \$115 million to its affiliate Comcast CAP of Philadelphia, Inc. ("Comcast CAP"), as part of the first step in TCG's acquisition of Eastern TeleLogic Corporation. The remaining funds were and will be used to expand and develop existing and new networks, to repay the TCI Subordinated Note, to make acquisitions and for general corporate and working capital purposes.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

(In thousands)

	Consolidated 1997	Consolidated 1996	Combined 1995
Cash flows from operating activities:			
Net loss	\$(222,667)	\$ (114,850)	\$ (53,804)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities, net of effects of the TCG Reorganization and acquisitions:			
Depreciation and amortization	155,402	78,416	37,837
Amortization of notes costs	2,702	1,350	—
Equity in losses of unconsolidated affiliates	3,427	19,400	19,541
In-process research and development costs	22,000	—	—
Amortization of deferred credits	(18,178)	(2,965)	(2,228)
Provision for losses on accounts receivable	11,526	3,442	877
Accretion of discount on Senior Discount Notes	75,417	34,567	—
Minority interest	—	(3,520)	(663)
Other	(1,914)	—	—
(Increase) decrease in operating assets and (decrease) increase in operating liabilities:			
Accounts receivable	(48,608)	(18,386)	(12,771)
Other assets	(21,786)	(3,596)	(3,108)
Accounts payable and accrued liabilities	(3,709)	97,230	45,832
Deferred credits	25,177	2,530	4,628
Net cash (used in) provided by operating activities	(21,211)	93,618	36,141
Cash flows from investing activities:			
Capital expenditures	(462,791)	(294,078)	(139,656)
Due from related parties	—	(23,042)	(6,707)
Purchases of marketable securities, net of sales and maturities	134,166	(440,831)	—
Purchase of a Local Market Partnership interest	—	(11,618)	—
Capital contributions to Local Market Partnerships prior to TCG Reorganization	—	(16,435)	—
Investments in and advances to unconsolidated affiliates	(6,290)	(127,509)	(65,004)
Repayment of advances to unconsolidated affiliate	—	—	3,400
Cash paid for acquisitions, net of cash acquired	(6,709)	—	—
Net cash used for investing activities	(341,624)	(913,513)	(207,967)
Cash flows from financing activities:			
Proceeds from issuance of long-term debt	—	162,500	159,000
Payments on bank revolving credit facility	—	(250,000)	—
Proceeds from Senior Notes	—	300,000	—
Proceeds from Senior Discount Notes	—	625,000	—
Costs associated with the Offerings	(11,302)	(51,867)	—
Proceeds from the issuance of Class A Common Stock	328,699	432,400	—
Proceeds from the exercise of employee stock options	11,721	388	—
Purchase of treasury stock	—	(121,025)	—
Capital contributions from minority partners	—	—	2,168
Principal payments on capital leases	(45,399)	(11,823)	(3,480)
Repayment of TCI Subordinated Note, net of discount	(25,093)	—	—
Net cash provided by financing activities	258,626	1,085,573	157,688
Net (decrease) increase in cash and cash equivalents	(104,209)	265,678	(14,138)
Cash and cash equivalents, January 1	277,540	11,862	26,000
Cash and cash equivalents, December 31	\$ 173,331	\$ 277,540	\$ 11,862

The accompanying notes are an integral part of these financial statements.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY AND
PARTNERS' CAPITAL (DEFICIT)—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995
(In thousands, except share amounts)

	<u>Common Stock</u>	<u>Class B Common Stock</u>	<u>Additional Paid-In Capital</u>	<u>Unrealized Gain (Loss) On Marketable Securities</u>	<u>Accumulated Deficit</u>	<u>Partners' Capital (Deficit)</u>	<u>Treasury Stock</u>	<u>Total Stockholders' Equity and Partners' Capital (Deficit)</u>
Issuance of 7,304,408 shares of Class A Common Stock, net of issuance costs of \$11.3 million	73	—	317,324	—	—	—	—	317,397
Issuance of 990,639 shares of Class A Common Stock upon exercise of options and employee stock grants	9	—	16,484	—	—	—	—	16,493
Issuance of 2,100,000 shares of Class A Common Stock to purchase CERFnet Services, Inc . . .	21	—	47,386	—	—	—	—	47,407
Issuance of 2,757,083 shares of Class A Common Stock to purchase remaining interest in Eastern TeleLogic Corporation	28	—	46,050	—	—	—	—	46,078
Issuance of 1,667,624 shares of Class A Common Stock to purchase the remaining interest in BizTel Communications, Inc.	17	—	29,832	—	—	—	—	29,849
Conversion of 17,785,592 shares of Class B Common Stock to Class A Common Stock	178	(178)	—	—	—	—	—	—
Unrealized gain on marketable securities	—	—	—	189	—	—	—	189
Net loss	—	—	—	—	(222,667)	—	—	(222,667)
Consolidated balance at December 31, 1997	<u>\$613</u>	<u>\$1,215</u>	<u>\$1,654,328</u>	<u>\$164</u>	<u>\$(503,679)</u>	<u>\$—</u>	<u>\$(121,025)</u>	<u>\$1,031,616</u>

The accompanying notes are an integral part of these financial statements.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY AND
PARTNERS' CAPITAL (DEFICIT)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995
(In thousands, except share amounts)

	Common Stock	Class B Common Stock	Additional Paid-In Capital	Unrealized Gain (Loss) On Marketable Securities	Accumulated Deficit	Partners' Capital (Deficit)	Treasury Stock	Total Stockholders' Equity and Partners' Capital (Deficit)
Combined balance at January 1, 1995	\$ 2	\$ —	\$ 195,388	\$—	\$ (33,261)	\$17,023	\$ —	\$179,152
Net loss	—	—	—	—	(32,387)	(21,417)	—	(53,804)
Combined balance at December 31, 1995	2	—	195,388	—	(65,648)	(4,394)	—	125,348
Issuance of 27,025,000 shares of Class A Common Stock, net of issuance costs of \$24.8 million	270	—	407,374	—	—	—	—	407,644
Conversion of and 42,000 to 1 stock split of \$1.00 par value Common Stock to 139,250,370 shares of Class B Common Stock as part of the TCG Reorganization	(2)	1,393	307,828	—	(100,514)	4,394	—	213,099
Purchase of 7,975,738 shares of Class B Common Stock from Continental Cablevision, Inc.	—	—	—	—	—	—	(121,025)	(121,025)
Conversion of subordinated debt to parents plus accrued interest of \$20.6 million to equity	—	—	263,602	—	—	—	—	263,602
Issuance of 1,587,791 shares of Class A Common Stock to purchase the minority interests in two Local Market Partnerships	16	—	22,673	—	—	—	—	22,689
Issuance of 55,609 shares of Class A Common Stock upon exercise of options	1	—	387	—	—	—	—	388
Unrealized loss on marketable securities	—	—	—	(25)	—	—	—	(25)
Net loss	—	—	—	—	(114,850)	—	—	(114,850)
Consolidated balance at December 31, 1996	\$287	\$1,393	\$1,197,252	\$ (25)	\$ (281,012)	\$ —	\$ (121,025)	\$796,870

The accompanying notes are an integral part of these financial statements.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

STATEMENTS OF OPERATIONS

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

(In thousands, except share amounts)

	<u>Consolidated 1997</u>	<u>Consolidated 1996</u>	<u>Combined 1995</u>
Revenues:			
Telecommunications services (\$9,968, \$2,330 and \$154 with related parties in 1997, 1996 and 1995, respectively)	\$ 494,304	\$ 244,864	\$ 134,652
Management and royalty fees from affiliates	—	22,805	31,517
Total revenues	<u>494,304</u>	<u>267,669</u>	<u>166,169</u>
Expenses:			
Operating	283,440	157,591	93,118
Selling, general and administrative	165,977	85,025	50,475
In-process research and development costs	22,000	—	—
Depreciation and amortization	155,402	78,416	37,837
Total expenses	<u>626,819</u>	<u>321,032</u>	<u>181,430</u>
Operating loss	<u>(132,515)</u>	<u>(53,363)</u>	<u>(15,261)</u>
Interest:			
Interest income	31,111	30,219	4,067
Interest expense (\$2,022, \$14,997 and \$18,763 with related parties) in 1997, 1996 and 1995, respectively	(116,172)	(73,633)	(23,331)
Total interest	<u>(85,061)</u>	<u>(43,414)</u>	<u>(19,264)</u>
Loss before minority interest, equity in losses of unconsolidated affiliates and income tax provision	(217,576)	(96,777)	(34,525)
Minority interest	—	3,520	663
Equity in losses of unconsolidated affiliates	(3,427)	(19,400)	(19,541)
Loss before income tax provision	(221,003)	(112,657)	(53,403)
Income tax provision	(1,664)	(2,193)	(401)
Net loss	<u>\$ (222,667)</u>	<u>\$ (114,850)</u>	<u>\$ (53,804)</u>
Loss per share	<u>\$ (1.34)</u>	<u>\$ (1.00)</u>	<u>\$ (0.77)</u>
Weighted average number of shares outstanding	<u>165,728,059</u>	<u>114,443,695</u>	<u>70,000,140</u>

The accompanying notes are an integral part of these financial statements.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS—(Continued)

DECEMBER 31, 1997 AND 1996

(In thousands, except share amounts)

	<u>1997</u>	<u>1996</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities (\$4,019 in 1997 and \$1,079 in 1996 with related parties)	\$ 282,231	\$ 215,808
Current portion of capital lease obligations (\$28,172 in 1997 and \$21,139 in 1996 with related parties)	33,724	24,063
Short-term bank debt	52,575	—
Other current liabilities	6,742	2,365
Total current liabilities	<u>375,272</u>	<u>242,236</u>
Capital lease obligations (\$13,388 in 1997 and \$28,716 in 1996 with related parties)	19,095	34,489
Senior Notes	300,000	300,000
Senior Discount Notes	734,984	659,567
Unamortized notes costs	(23,059)	(25,761)
TCI Subordinated Note (including accrued interest of \$0 in 1997 and \$1,007 in 1996)	—	27,007
Other liabilities	18,393	15,689
Total liabilities	<u>1,424,685</u>	<u>1,253,227</u>
Commitments and contingencies		
Stockholders' equity:		
Common Stock, Class A \$.01 par value: 450,000,000 shares authorized, 61,273,746 and 28,668,400 shares issued and outstanding at December 31, 1997 and 1996	613	287
Common Stock, Class B \$.01 par value: 300,000,000 shares authorized, 121,464,778 and 139,250,370 shares issued and outstanding at December 31, 1997 and 1996	1,215	1,393
Additional paid-in capital	1,654,328	1,197,252
Unrealized gain (loss) on marketable securities	164	(25)
Accumulated deficit	(503,679)	(281,012)
	<u>1,152,641</u>	<u>917,895</u>
Less cost of Class B Common Stock held in treasury, 7,975,738 shares at December 31, 1997 and 1996	<u>(121,025)</u>	<u>(121,025)</u>
Total stockholders' equity	<u>1,031,616</u>	<u>796,870</u>
Total liabilities and stockholders' equity	<u>\$2,456,301</u>	<u>\$2,050,097</u>

The accompanying notes are an integral part of these financial statements.

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 1997 AND 1996

(In thousands)

	<u>1997</u>	<u>1996</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 173,331	\$ 277,540
Marketable securities	306,828	440,806
Accounts receivable:		
Trade—net of allowance for doubtful accounts (\$11,684 in 1997 and \$5,989 in 1996)	85,081	46,325
Related parties	6,351	4,191
Miscellaneous—net of allowance for doubtful accounts (\$297 in 1997 and \$1,406 in 1996)	6,639	6,795
Accounts receivable—net	98,071	57,311
Prepaid expenses	13,988	9,531
Other current assets	7,943	2,373
Total current assets	600,161	787,561
Fixed assets—at cost:		
Communications network	1,722,093	1,211,922
Other	150,990	92,307
	1,873,083	1,304,229
Less accumulated depreciation and amortization	(379,987)	(236,967)
Fixed assets—net	1,493,096	1,067,262
Investments in and advances to unconsolidated affiliates	8,822	126,561
Goodwill and other intangible assets, net of accumulated amortization (\$13,836 in 1997 and \$3,789 in 1996)	237,806	57,764
Licenses—net of accumulated amortization (\$183 in 1997)	39,503	—
Other assets	76,913	10,949
Total assets	<u>\$2,456,301</u>	<u>\$2,050,097</u>

The accompanying notes are an integral part of these financial statements.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of
Teleport Communications Group Inc.:

We have audited the accompanying consolidated balance sheets of Teleport Communications Group Inc. and its subsidiaries ("TCG") as of December 31, 1997 and 1996 and the related consolidated statements of operations, changes in stockholders' equity and partners' capital (deficit), and cash flows for the two years then ended and the related combined statements of operations, changes in stockholders' equity and partners' capital (deficit), and cash flows of Teleport Communications Group Inc. and its subsidiaries and TCG Partners ("TCGP"), which were under common ownership and management, for the year ended December 31, 1995. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the consolidated financial position of TCG and subsidiaries at December 31, 1997 and 1996 and the results of their operations and their cash flows for the years ended December 31, 1997 and 1996 and the results of the combined operations and cash flows of TCG and TCGP for the year ended December 31, 1995 in conformity with generally accepted accounting principles.

DELOITTE & TOUCHE LLP
New York, New York
March 3, 1998

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES
INDEX TO AUDITED FINANCIAL STATEMENTS

	<u>Page</u>
Independent Auditors' Report	F-1
Balance Sheets at December 31, 1997 and 1996	F-2
Statements of Operations for the Years Ended December 31, 1997, 1996 and 1995	F-4
Statements of Changes in Stockholders' Equity and Partners' Capital (Deficit) for the Years Ended December 31, 1997, 1996 and 1995	F-5
Statements of Cash Flows for the Years Ended December 31, 1997, 1996 and 1995	F-7
Notes to Financial Statements	F-8

PART IV

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a)(1) INDEX TO FINANCIAL STATEMENTS

The following Audited Financial Statements of the Company are filed as part of this Report:

	<u>Page</u>
Independent Auditors' Report	F-1
Balance Sheets at December 31, 1997 and 1996	F-2
Statements of Operations for the Years Ended December 31, 1997, 1996 and 1995	F-4
Statements of Changes in Stockholders' Equity and Partners' Capital (Deficit) for the Years Ended December 31, 1997, 1996 and 1995	F-5
Statements of Cash Flows for the Years Ended December 31, 1997, 1996 and 1995	F-7
Notes to Financial Statements	F-8

(a)(3) INDEX TO EXHIBITS

See attached Index to Exhibits on pages X-1 through X-2 of this Form 10-K.

(b) REPORTS ON FORM 8-K

The following reports on Form 8-K were filed during the Company's quarter ended December 31, 1997:

A report on Form 8-K, dated October 10, 1997, was filed reporting Registrant's filing of a registration statement for the 1997 Equity Offering.

A report on Form 8-K, dated October 29, 1997, was filed reporting Registrant's financial results for the fiscal quarter ended September 30, 1997.

A report on Form 8-K, dated October 30, 1997, was filed reporting Registrant's completion of the acquisition of BizTel Communications, Inc.

A report on Form 8-K, dated November 26, 1997, was filed reporting Registrant's agreement to acquire ACC Corp. in a stock-for-stock merger.

A report on Form 8-K, dated December 2, 1997, was filed reporting Registrant's agreement to acquire the assets and customer base of Kansas City Fiber Network, L.P.

The Year 2000

The Year 2000 problem arises from the fact that due to early limitations on memory and disk storage many computer programs indicate the year by only two digits, rather than four. This limitation can cause programs (both system and application) that perform arithmetic operations, comparisons, or sorting of data fields to yield incorrect results when working outside the year range of 1900-1999. TCG began its investigation into Year 2000 compliance in the fourth quarter of 1996 and expects to complete its analysis during 1998. The analysis covers all network equipment used to provide services to TCG customers, network operations support systems used to support the operations of its networks, and all administrative support systems. TCG is working closely with its vendors to effectuate their Year 2000 correction plans on a timely basis. There can be no assurance that such procedures will be successfully implemented within the required time frames or that additional procedures will not be necessary. A failure of TCG's or of its significant vendors' computer systems could have a material adverse effect on TCG's business and financial position and results of operations. The cost to TCG of the procedures to correct the Year 2000 problem is currently estimated at \$5.0 million.

Item 7A. *Quantitative and Qualitative Disclosure about Market Risk*

Not Applicable

Item 8. *Financial Statements and Supplementary Data*

The Registrant's financial statements are included in this report beginning on page F-1.

Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure*

None.

PART III

Item 10. *Directors and Executive Officers of the Company*

Directors

The information concerning directors of the Company required under this item is incorporated by reference to the Proxy Statement to be filed in connection with the Registrant's Annual Meeting of Shareholders (the "Proxy Statement").

Executive Officers

The information concerning executive officers of the Company required under this item is incorporated by reference to the Proxy Statement.

Item 11. *Executive Compensation*

The information required under this item is incorporated by reference to the Proxy Statement.

Item 12. *Security Ownership and Certain Beneficial Owners and Management*

The information required under this item is incorporated by reference to the Proxy Statement.

Item 13. *Certain Relationships and Related Transactions*

The information required under this item is incorporated by reference to the Proxy Statement.

general corporate and working capital purposes, which may include acquisitions. A significant portion of such proceeds will be contributed or advanced to the Company's subsidiaries which own and operate the networks in the local markets. Expected capital expenditures for the expansion, development and acquisition of networks and other telecommunications assets include (i) the purchase and installation of switches, electronics, fiber and other additional technologies in existing networks and in networks to be constructed in new markets and (ii) the acquisition and expansion of networks and other telecommunications assets currently owned and operated by other companies. Expected expenditures for general corporate and working capital purposes include (i) expenditures with respect to the Company's management information systems and corporate service support infrastructure and (ii) operating and administrative expenses with respect to new networks and debt service.

The Company, to meet its capital requirements in 1998, intends to raise additional capital. TCG will continue to take advantage of favorable financing arrangements, including the sale of debt or equity securities in the public markets, private placements, increasing the amount available under the existing credit facilities or adding additional lines of credits. The AT&T Agreement provides that the Company must offer AT&T the right to provide financing which the Company proposes to engage in with third party lenders or other financing sources on the same terms and conditions as the Company could have obtained from such lenders or other sources.

The Company from time to time evaluates acquisitions and investments in light of TCG's long range plans. Such acquisitions and investments, if realized, could use a material portion of TCG's financial resources and may accelerate the need for raising additional capital in the future.

Certain of the matters discussed in this report may be forward-looking within the meaning of Section 21E of the Securities Exchange Act of 1934. For example, the acquisition and integration of ACC and the proposed AT&T Merger are subject to inherent uncertainties outside of TCG's control, and there can be no assurance that ACC will perform in accordance with past results or expectations or that either the ACC Merger or the AT&T Merger will be consummated. Factors that could adversely effect TCG's integration and operation of ACC include certain considerations discussed under the caption "Risk Factors" in the ACC S-4, and factors that could adversely effect TCG's operations generally include certain considerations discussed under the caption "Risk Factors" in TCG's Registration Statement on Form S-3 (File No. 333-37597). Such factors could cause future results to vary materially from TCG's historical results of operations filed in the ACC S-4.

Effects of Recently Issued Accounting Standards

Comprehensive Income—In June 1997, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 130 "Reporting Comprehensive Income." This statement is effective for financial statements issued for periods beginning after December 15, 1997. Management has evaluated the effect on its financial reporting from the adoption of this statement and has found the majority of the disclosures to be not applicable and the remainder to be not significant.

Segments of an Enterprise and Related Information—In June 1997, the FASB also issued SFAS No. 131 "Disclosure about Segments of an Enterprise and Related Information." This statement is effective for fiscal years beginning after December 15, 1997. SFAS No. 131 requires the reporting of profit and loss, specific revenue and expense items, and assets for reportable segments. It also requires the reconciliation of total segment revenues, total segment profit or loss, total segment assets, and other amounts disclosed for segments to the corresponding amounts in the general purpose financial statements. The Company has not yet determined what additional disclosures may be required in connection with adopting SFAS 131.

Effects of Inflation

Inflation has not had a significant effect on the Company's operations. However, there can be no assurance that inflation will not have a material effect on the Company's operations in the future.

(realizing net proceeds of approximately \$317.4 million after deducting the underwriting discount and expenses of approximately \$11.3 million to the Company) and 9,945,592 shares were offered by Continental Holding Company, a Massachusetts business trust, the shares of which are owned by Continental, which is wholly owned by U S WEST, Inc. Continental acquired its interest in TCG in May 1993. As a result of the consummation of the 1997 Equity Offering, Continental does not hold any shares of TCG Common Stock.

TCG has invested the proceeds from the 1996 Offerings and the 1997 Equity Offering in marketable securities such as Treasury bills, floating rate notes and commercial paper. TCG will utilize the remaining proceeds to expand its networks, for acquisitions and to provide funds for working capital.

Available Credit

Effective as of March 1, 1997, TCG completed its acquisition of ETC. As part of the acquisition, TCG assumed ETC's credit facility with an outstanding amount of \$52.6 million. This facility, which ETC entered into in October 1995, is a \$60.0 million credit facility (the "ETC Facility") with certain banks. The ETC Facility provides for interest based upon either the base rate, or London Interbank Offered Rate ("LIBOR"), adjusted as defined in the ETC Facility (7.4375% at December 31, 1997), which is payable quarterly. The balance outstanding is due on September 30, 1998. Borrowings under the ETC Facility are collateralized by substantially all of the assets and outstanding common stock of TCG Delaware Valley, Inc. In addition, the ETC Facility contains certain restrictive covenants which, among other things, requires TCG Delaware Valley to maintain certain debt service coverage ratios and limit the payment of dividends and capital expenditures. TCG is currently in compliance with the terms of the covenants. In addition, TCG Delaware Valley is required to pay .375% per year on the available portion of the ETC Facility. The total outstanding balance at December 31, 1997, was \$52.6 million.

To finance TCG's capital expenditures, acquisitions, investments, working capital and for other general corporate purposes, TCG's wholly-owned subsidiary, TCG New York, Inc. ("TCGNY"), amended its \$250 million Revolving Credit Agreement to a \$400 million Revolving Credit Agreement on July 28, 1997. The Revolving Credit Agreement is secured by (i) the stock of the following TCGNY wholly-owned subsidiaries: TC New York Holdings I, Inc., TC New York Holdings II, Inc., TC Systems, Inc., TCG Payphones, Inc. and the partnership interests in Teleport Communications, (ii) a negative pledge on the assets and a pledge of the stock of each existing and future subsidiary of TCGNY, (iii) a negative pledge on the contracts that relate to TCGNY operations, (iv) upstream guarantees from any existing and future subsidiaries of TCGNY and (v) a lien on all present and future intercompany indebtedness owned to TCGNY from TCG and all of its subsidiaries. There is no outstanding balance as of December 31, 1997. As of December 31, 1997, \$344.4 million was available to TCG under the Revolving Credit Agreement.

The Revolving Credit Agreement contains various covenants and conditions, including restrictions on additional indebtedness, maintenance of certain financial ratios and limitations on capital expenditures TCG is currently in compliance with the terms of these covenants. None of these covenants negatively impact TCG's liquidity or capital resources at this time. In addition, TCG is required to pay .375% per year on the available portion of the Revolving Credit Agreement.

Future Commitments

TCG has agreed to purchase substantially all of the assets used in connection with the fiber optic communications system of Kansas City Fiber Network, L.P., a CLEC, a majority of the equity of which is owned by TCI and Time Warner Communications. Pending the closing of such transaction, TCG is providing certain services in connection with the operations of such communications system, which is located in the Kansas City, Missouri/Overland Park, Kansas metropolitan area. The purchase price is approximately \$55 million in cash and TCG will be required to assume certain obligations of the seller.

TCG intends to use the net proceeds from the sale of its shares pursuant to the 1997 Equity Offering and the remaining proceeds from the 1996 Offerings to expand and develop existing and new networks and for

proceeds from the 1997 Equity Offering and to a lesser extent from the exercise of employee stock options, and such cash flows were partially offset by the repayment of the TCI Subordinated Note and principal payments on capital leases. Cash flows from financing activities for 1996 consisted primarily of proceeds from the 1996 Offerings and the issuance of long-term debt, partially offset by the repayment of outstanding bank indebtedness and the purchase of treasury stock. Net cash (used in) provided by operating activities was \$(21.2) million and \$93.6 million for the years ended December 31, 1997 and 1996, respectively. Net cash used for investing activities was \$341.6 million and \$913.5 million for the years ended December 31, 1997 and 1996, respectively, comprised primarily of capital expenditures and purchases of marketable securities in both years offset by the sale of certain marketable securities and investment in and advances to unconsolidated affiliates in 1996. As of December 31, 1997, cash and cash equivalents were \$173.3 million and marketable securities were \$306.8 million.

TCG made capital expenditures of \$501.0 million and \$358.2 million on a pro forma basis for the years ended December 31, 1997 and 1996, respectively. The Company anticipates that capital expenditures (excluding acquisitions) will be in excess of \$1.1 billion in the aggregate in 1998, and will primarily be used for the expansion, development and construction of its networks, the acquisition and deployment of switches and the expansion of operating support systems.

Earnings before fixed charges were insufficient to cover fixed charges for the year ended December 31, 1997 and 1996 by \$221.0 million and \$116.2 million, respectively. On a pro forma basis for the TCG Reorganization, the Company's earnings would have been insufficient to cover fixed charges for the year ended December 31, 1996 by \$129.1 million.

TCG has incurred significant net operating losses resulting from the development and operation of new networks which TCG expects will continue as it expands its networks. Persistent demands from TCG's customers for capital intensive local services drives the development, construction and expansion of its networks. While cash provided by operations may be sufficient to fund modest incremental growth it may not be sufficient to fund the extensive expansion and development of networks as currently planned.

Offerings

On July 2, 1996, TCG issued 27,025,000 shares of TCG Class A Common Stock which resulted in gross proceeds of approximately \$432.4 million as part of an initial public offering, \$300 million of 1996 Senior Notes and \$1.073 million aggregate principal amount at maturity of 1996 Senior Discount Notes. Prior to the 1996 Offerings, TCG was owned by subsidiaries of the Cable Stockholders. The business was operated through TCG and, beginning in 1992, TCG Partners, which is a New York general partnership owned prior to the TCG Reorganization by the Cable Stockholders in the same percentages as TCG. TCG Partners was formed to invest, with TCG, the Cable Stockholders and other cable operators, in 14 Local Market Partnerships to develop and operate local telecommunications networks. The Local Market Partnerships were owned by TCG, and/or TCG Partners, certain of the Cable Stockholders which had cable operations in the particular markets addressed by the Local Market Partnerships and, in some cases, other cable operators in such markets. To simplify this complex ownership structure, the Company and the Cable Stockholders completed the TCG Reorganization whereby, TCG agreed to consolidate the ownership of TCG Partners and of the Local Market Partnerships as wholly-owned subsidiaries of TCG. As part of this process, certain of the other cable operators agreed to sell their interests in the Local Market Partnerships to TCG directly or through a Cable Stockholder. See "Business—The TCG Reorganization". The financial statements for one of the Local Market Partnerships were previously consolidated with those of TCG. Therefore, as a result of the TCG Reorganization TCG consolidated the financial statements of only 13 of the 14 Local Market Partnerships.

On November 13, 1997, TCG consummated a public offering of 17,250,000 shares of TCG Class A Common Stock (the "1997 Equity Offering"). Of the 17,250,000 shares, 7,304,408 shares were offered by TCG